

Financial Law Governance Measures for Local Government Debt Risk

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Abstract: Against the backdrop of slowing economic growth and continuous promotion of new urbanization, local governments have continued to increase their debt scale in order to make up for the fiscal revenue and expenditure gap and expand infrastructure investment, leading to increasingly obvious hidden debt risks. Financial law governance plays a crucial role as an important mechanism for achieving a balance between debt development and risk prevention and control through institutional norms and constraints. We should comprehensively build a unified local government debt governance system covering the entire process of "borrowing, using, managing, and repaying" through legal means such as improving the legal system of debt, strengthening the supervision of the entire budget process, promoting the classification and resolution of existing debts, and establishing a market-oriented legal constraint mechanism, in order to effectively prevent systemic financial risks and ensure economic security and fiscal sustainability.

1. Introduction

Local government debt refers to the obligations formed by local governments through debt financing in order to complete public functions such as infrastructure construction and public service supply, when there is a fiscal gap between revenue and expenditure. Moderate debt financing can to some extent make up for the insufficient local financial resources and play a positive role in promoting economic and social development; However, without effective institutional constraints, the excessive expansion of debt scale may trigger debt repayment crises, and even further affect regional financial stability and national economic security through the dual risk transmission mechanism of fiscal and financial. Financial rule of law, as the institutional foundation for regulating government and market behavior, plays an important role in preventing and resolving local government debt risks. It is of great practical significance to establish a sound legal framework, strengthen institutional constraint mechanisms, and improve regulatory coordination efficiency, ultimately forming an organic combination of rule of law, marketization, and transparency in debt governance system.

2. The manifestations and causes of local government debt risks

2.1. Main manifestations of risk

At present, the risk of local government debt exhibits complex characteristics of interweaving explicit and implicit debt, including the following manifestations: firstly, there is a clear mismatch of maturity, with debt maturity mostly concentrated in 3 to 5 years, while the corresponding infrastructure project investment payback period often exceeds 10 years, making it difficult for project cash flow to effectively repay debt principal and interest; Secondly, the guarantee methods are complex. Local governments increase the credit of financing platforms by issuing commitment letters, comfort letters, or providing financial support, thus forming an implicit link between government credit and corporate debt[1]; Thirdly, there are significant regional differences. In the central and western regions and some grassroots governments, due to the slowdown in fiscal revenue growth, their debt ratios have exceeded the warning line of 100%. If these risks continue to accumulate, they may trigger a series of chain reactions such as local financial defaults, platform company bankruptcies, and decreased investor confidence, ultimately posing a serious threat to regional financial stability.

2.2. The deep-seated causes of risk

Firstly, there is a structural contradiction between the fiscal decentralization system and the allocation of powers, which is an important institutional reason for the formation of risks. In the current fiscal arrangement in our country, local governments bear the vast majority of public service expenditures, accounting for about 85%, including education, healthcare, and social security. However, local tax revenue only accounts for about 50% of the national fiscal revenue. The significant gap between income and expenditure has forced local governments to rely heavily on borrowing to maintain their operations. At the same time, under the incentive model of "promotion tournament", local governments show a clear tendency to "actively increase debt" in order to pursue GDP growth and highlight political achievements.

Secondly, the problem of soft budget constraints and the lag in legal supervision further exacerbate the accumulation of risks. Although the Budget Law has clearly stipulated that local governments can only legally borrow money through the issuance of local government bonds, in practice, there are still a large number of financing behaviors that evade regulation, such as using financing platforms, non-standard PPP projects, and other "detour borrowing" practices[2]. Common methods include disguising actual construction financing under the guise of government purchasing services, or packaging construction projects as service procurement; There are also ways to attract social capital through the structure of "clear stocks and actual debts", in order to avoid the legal limit on debt size.

Finally, irrational behavior in financial markets also plays a driving and exacerbating role in the formation and amplification of risks. Some financial institutions, especially banks and trust companies, tend to provide excessive loans to local governments in pursuit of higher profits. On the one hand, due to blind trust in government credit, financing platform loans are often regarded as low-risk assets, even if the related projects themselves lack sufficient cash flow; On the other hand, by designing complex financial products to bypass financial regulation and provide funding for implicit debt. The situation of "government and bank working together" has actually significantly increased the level of debt risk.

3. Effective countermeasures for financial law governance of local government debt risk

3.1. Clarify the boundaries of rights and responsibilities and regulate the responsible parties

Firstly, in order to improve the management system of local government debt, it is necessary to revise the relevant supporting rules of the Budget Law and further refine the specific rules for the issuance of local government bonds. The scope of application of general bonds and special bonds should be clearly distinguished: general bonds are applicable to non-profit public welfare projects, while special bonds are limited to non-profit public welfare projects with returns. In terms of quota allocation, a mechanism should be established that is linked to the quality of project reserves and the debt paying ability of local governments, and information disclosure requirements should be improved, including disclosure of key indicators such as expected project returns and cash flow coverage ratios[3]. At the same time, it is strictly prohibited to add implicit debt under the name of "replacement debt", such as prohibiting the act of replacing high interest short-term debt with low interest long-term debt but actually expanding the total amount of debt.

Secondly, efforts should be made to promote the formulation of the "Regulations on the Management of Local Government Debt", with a focus on providing institutional responses to implicit debt issues. The regulations should clarify the market-oriented transformation path of financing platform companies, including specific requirements such as divesting government financing functions, prohibiting the addition of implicit government guarantees, and prohibiting local governments from illegally borrowing through government purchasing services, industrial funds, PPP and other channels. Clear legal responsibilities should be established for behaviors such as "clear stocks and actual debts" and financial guarantees, and relevant responsible persons should be subject to administrative sanctions in accordance with the law. If a crime is committed, criminal responsibility should also be pursued.

Finally, the legal binding force of the official accountability mechanism should be strengthened. The government and relevant departments should incorporate government debt risk indicators such as the debt ratio and the debt service ratio into the performance assessment of leading cadres and implement a lifelong accountability system. Officials who engage in illegal and irregular borrowing during their term of office and cause significant debt losses, even if they have been transferred from their original positions, shall be held accountable in accordance with the law[4]. At the same time, it is necessary to establish a complete institutional system from debt audit supervision, responsibility identification procedures to accountability execution mechanisms, to ensure that the accountability system is truly implemented and avoid becoming a formality.

3.2. Strengthen budget constraints and full process supervision

Strengthening budget management requires incorporating all local government debts into the budget system, including explicit and implicit debts. Provincial governments must develop annual debt plans that clearly state the purpose, repayment source, and risk level of each debt. The money for general bonds should be managed in the general public budget, while the money for special bonds must correspond to specific projects and be included in the government fund budget to ensure that the funds are used for actual projects. At the same time, it is not allowed to use debt funds for unnecessary construction projects such as image projects and performance projects, nor can they be used to make up for daily expenditure gaps.

In terms of dynamic monitoring and early warning, a unified local government debt risk monitoring platform should be established, integrating data from multiple departments such as finance, banking, and development and reform, mainly including debt balance, repayment plan, platform loans, bond issuance, and project approval information, in order to monitor important

indicators such as debt size, maturity structure, and repayment fund coverage in real time. For high-risk areas with a debt ratio exceeding 120%, borrowing should be restricted, such as suspending the issuance of new bonds and initiating fiscal restructuring measures. Specific measures can be taken, such as reducing general expenditures and disposing of state-owned assets, in order to effectively prevent and resolve debt risks.

To enhance the synergistic effect of financial regulation, financial regulatory authorities should strengthen compliance reviews of local government financing businesses. Specifically, it is strictly prohibited for financial institutions to provide financing to projects without sustainable cash flow, and it is also strictly forbidden to accept any form of guarantee commitment provided by local governments in violation of regulations[5]. In addition, penetrative supervision should be implemented on local government financing platform companies, with a focus on monitoring the loan concentration risk of financing platforms within the banking system.

3.3. Promote market-oriented and rule of law disposal

In promoting market-oriented and rule of law debt disposal mechanisms, classified policies should be implemented to resolve existing debts. Firstly, for legitimate and compliant explicit debts, they can be exchanged through the issuance of refinancing bonds, which helps to reduce the interest burden and optimize the debt maturity structure, achieving a matching between the debt repayment cycle and the project income cycle. Secondly, for implicit debt, the principle of "whoever borrows should be responsible" should be strictly followed, and differentiated solutions should be formulated. Finally, for "zombie platforms" that are in a high-risk state, bankruptcy reorganization procedures should be implemented in accordance with the law, and market clearance should be achieved through the cancellation of invalid debts or the promotion of mergers and acquisitions.

Standardize the cooperation model between government and social capital: To ensure fiscal sustainability, it is necessary to strictly limit the financial expenditure responsibility scale of PPP projects, stipulating that it shall not exceed 10% of the general public budget expenditure. At the same time, it is absolutely prohibited to indirectly increase government debt through fixed returns, repurchase arrangements, and other forms. All PPP projects must complete financial capacity assessment and value for money evaluation, and include project contracts that include government payment commitments in budget management in accordance with the law. For PPP projects that violate regulations, immediate rectification should be required, and the legal responsibilities of relevant responsible parties should be pursued in accordance with the law[6].

Improve the judicial relief and bankruptcy system: It is necessary to clearly define the legal debt attributes of local government bonds and allow investors to diversify investment risks through market-oriented mechanisms, such as bond secondary market transfers. When dealing with debt disputes of financing platform companies, judicial authorities should strictly distinguish between government credit endorsement and market-oriented financing behavior; Government guarantee commitments lacking legal basis should not be given judicial support. For financing platform companies with insolvency, bankruptcy proceedings should be initiated in accordance with the Enterprise Bankruptcy Law, and priority should be given to safeguarding livelihood related debts such as employee wages and social insurance during this process, in order to effectively prevent the occurrence and accumulation of social risks.

4. Conclusion

The risk of local government debt essentially brings two issues, one is whether the finance can be sustained, and the other is whether the finance is stable. To solve this problem, we must rely on the overall support of the financial rule of law system. We need to improve relevant laws and clarify the

government's authority and responsibility for borrowing; Strengthen budget constraints and standardize the use of debt funds; Gradually reduce existing debt risks through market mechanisms. At the same time, we must promote a social atmosphere of acting in accordance with the law and achieve the participation of the whole society. This is the only way to establish a debt management mechanism that combines "legal constraints" and "market operation".

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